



**REPORT OF THE AUDITOR OF PUBLIC ACCOUNTS
AUDIT OF THE REVENUE CABINET**

**Made as Part of the Statewide Single Audit
of the Commonwealth of Kentucky**

For the Year Ended June 30, 1998

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None Noted For The Audit Period Ending June 30, 1998

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INTRODUCTION

KENTUCKY REVENUE CABINET
INTRODUCTION
FOR THE YEAR ENDED JUNE 30, 1998

Introduction

The Auditor of Public Accounts, acting as principal auditor in conjunction with various certified public accounting firms, annually performs a statewide single audit of the Commonwealth of Kentucky. This audit allows the Commonwealth to comply with federal audit requirements as set forth in the Single Audit Act of 1984, as amended by Public Law 104-156, and the regulations contained in the U.S. Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Public Law 104-156, referred to as the Single Audit Act Amendments of 1996, is effective for fiscal years beginning after June 30, 1996.

Audit Approach

Our audit was conducted in accordance with generally accepted auditing standards, Government Auditing Standards, the Single Audit Act Amendments of 1996, and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. The scope of the statewide single audit for the year ended June 30, 1998, included:

- An audit of the general-purpose financial statements and required supplementary schedules in accordance with generally accepted government auditing standards;
- An audit of internal control applicable to the Kentucky Revenue Cabinet, to the extent necessary to consider and test the internal accounting and administrative control systems as required by generally accepted government auditing standards, the Single Audit Act Amendments of 1996, and the provisions of OMB Circular A-133.

The Auditor of Public Accounts' office conducted the audit of the internal control focusing on the following objectives:

- Considering the internal control in order to determine auditing procedures on the general-purpose Financial Statements of the Commonwealth of Kentucky.

**KENTUCKY REVENUE CABINET
INTRODUCTION
FOR THE YEAR ENDED JUNE 30, 1998
(CONTINUED)**

List Of Abbreviations/Acronyms Used In This Report

DOA	Division of Accounts
FY	Fiscal Year
ID	Identification
JV	Journal Voucher
KITES	Kentucky Integrated Tax Entity System
KRC	Kentucky Revenue Cabinet
KRS	Kentucky Revised Statutes
LP	Liquid Petroleum
MFE	Modernized Front End
NA	Not Applicable

REPORT ON COMPLIANCE AND ON INTERNAL CONTROL



Edward B. Hatchett, Jr. Auditor of Public Accounts

To the People of Kentucky
Honorable Paul E. Patton, Governor
Mike Haydon, Secretary
Kentucky Revenue Cabinet

Report On Compliance And On Internal Control Over Financial Reporting Based On An Audit Of General-Purpose Financial Statements Performed In Accordance With Government Auditing Standards

As part of the audit of the general-purpose financial statements of the Commonwealth of Kentucky as of and for the year ended June 30, 1998, we have audited receipts, refunds, account receivables, and contingent liabilities of the Kentucky Revenue Cabinet, an organizational unit of the Commonwealth of Kentucky as defined by KRS 12.010, and have issued our report thereon dated January 26, 1999. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in Government Auditing Standards issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Commonwealth of Kentucky's financial statements are free of material misstatement, we performed tests of Kentucky Revenue Cabinet's compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under Government Auditing Standards.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Kentucky Revenue Cabinet's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level, the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. However, we noted other matters involving the internal control over financial reporting that we have reported to management of the Kentucky Revenue Cabinet.

To the People of Kentucky
Honorable Paul E. Patton, Governor
Mike Haydon, Secretary
Kentucky Revenue Cabinet
Report On Compliance And On Internal Control Over
Financial Reporting Based On An Audit Of General-Purpose
Financial Statements Performed In Accordance With Government Auditing Standards
(Continued)

This report is intended solely for the information and use of management and applicable federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties. However, this report, upon release by the Auditor of Public Accounts, is a matter of public record and its distribution is not limited.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Ed Hatchett", with a long horizontal flourish extending to the right.

Edward B. Hatchett, Jr.
Auditor of Public Accounts

Audit fieldwork completed –
January 26, 1999

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

KENTUCKY REVENUE CABINET
SCHEDULE OF FINDINGS AND QUESTIONED COSTS
FOR THE YEAR ENDED JUNE 30, 1998

SECTION 1 – SUMMARY OF AUDITOR’S RESULTS

Financial Statement Accounts And Schedule Of Expenditures Of Federal Awards

Financial Statement Accounts: We issued a qualified opinion on the Commonwealth of Kentucky’s general-purpose financial statements, which include the Revenue Cabinet, as of and for the fiscal year ended June 30, 1998, because we were unable to verify evidence regarding year 2000 disclosures.

Schedule of Expenditures of Federal Awards: This section is not applicable to the Revenue Cabinet.

Internal Control Over Financial Reporting: Our consideration of the Revenue Cabinet’s internal control over financial reporting disclosed no reportable conditions.

Compliance: In relation to the audit of the Revenue Cabinet’s accounts that we audited, the results of our tests disclosed no instances of noncompliance that are required to be reported under generally accepted government auditing standards.

Federal Awards

This section is not applicable to the Revenue Cabinet.

Identification Of Major Program Audited

This section is not applicable to the Revenue Cabinet.

Dollar Threshold Used To Distinguish Between Type A And Type B Programs

The dollar threshold used to distinguish between Type A and Type B Programs was \$12 million.

Auditee Qualified As Low-Risk Auditee?

The Commonwealth did not qualify as a low-risk auditee.

**KENTUCKY REVENUE CABINET
SCHEDULE OF FINDINGS AND QUESTIONED COSTS
FOR THE YEAR ENDED JUNE 30, 1998
(CONTINUED)**

SECTION 2 – FINANCIAL STATEMENT FINDINGS AND QUESTIONED COSTS

Other Matters Relating To Internal Controls And/Or Compliance:

FINDING 98-KRC-1: The Revenue Cabinet Should Properly Safeguard Returns

The Central Files area appears to have inadequate procedures and/or personnel for ensuring that documents are properly filed and readily retrievable.

During testing of Accounts Receivable, the following were noted:

- Twenty-five Tax Notices/Forms 204 were requested to test controls on recording payments. Five of the requested 25 Tax Notices/Form 204 could not be located at Central Files. The Notice Numbers for the five missing Tax Notices/Forms 204 are: 100562405; 100502943; 100062578; 100666143; and, 100393560.

During testing of Refunds, the following were noted:

- Of 25 Refund Offsets tested, 6 items did not have the "Refund Offset System Detail of JV Listing" attached to the return to explain the date, amount, and agency for the offset. These forms could not be found in Central Files anywhere.
- Of 25 Individual Income Tax DOA-26s requested, Central Files was unable to locate 3 of them. Therefore, the auditor was unable to test these documents or obtain the information to request the returns associated with them.
- Of 25 Corporate Income Tax DOA-26s requested, Central Files was unable to locate 3 of them. Therefore, the auditor was unable to test these documents or obtain the information to request the corporate folders associated with them.

During the testing of Motor Fuels Tax Dealer Returns, the following were noted:

- Eighteen of the 45 reports that were requested could not be located. These reports consisted of Gasoline Returns, Special Fuels, and LP Dealers.

During the testing of Individual Income Tax, the following were noted:

- Five of the 27 Individual Declarations that were requested could not be located.

When documents cannot be located, proper administration of the tax laws is jeopardized. Taxpayer information could be considered incomplete when original documents are misplaced or misfiled. This compromises the ability of the Revenue Cabinet to properly document taxpayers accounts.

**KENTUCKY REVENUE CABINET
SCHEDULE OF FINDINGS AND QUESTIONED COSTS
FOR THE YEAR ENDED JUNE 30, 1998
(CONTINUED)**

**SECTION 2 – FINANCIAL STATEMENT FINDINGS AND QUESTIONED COSTS
(CONTINUED)**

Other Matters Relating To Internal Controls And/Or Compliance:

FINDING 98-KRC-1: The Revenue Cabinet Should Properly Safeguard Returns (Continued)

Recommendation

We recommend that proper procedures are followed to ensure that all tax documents are properly filed. Backlogs, when present, should be cleared up as soon as possible.

Management's Response and Corrective Action Plan

The Kentucky Revenue Cabinet (KRC) agrees with the findings that limited staffing resources are available at times in Central Files. However, the Division of Revenue Operations management will provide "refresher training" to Central Files employees to ensure that procedures are properly followed in the future. If unable to locate a tax return or document in Central Files, employees will also be instructed to contact the appropriate taxing area i.e., Miscellaneous Tax Branch to determine whether they still have the return or document. The proposed Modernized Front End (MFE) for data capturing and document processing will provide the KRC with the ability to store and retrieve tax returns and documents electronically. In addition, any paper returns requisitioned from Central Files will be scanned and imaged for future access, if necessary.

FINDING 98-KRC-2: The Revenue Cabinet Data Entry Section Supervisor Should Ensure That All Batches Are Keyed And Verified By Separate Operators

Our review of the data entry logs maintained by the Revenue Cabinet revealed eleven instances where the logs were not kept properly. The following exceptions were noted:

- Three instances where the verifying operator number was missing.
 - All three occurred in the Corporation Tax area.
- Six instances where the keying and verifying operator numbers were the same.
 - One occurrence in Accounts Receivable
 - One occurrence in Declaration
 - One occurrence in A-Series
 - Three occurrences in Refunds
- Two instances where an operator keyed part of the batch and then verified the whole batch.
 - One occurrence in Accounts Receivable
 - One occurrence in Refunds

Not having complete data entry logs, or ensuring that data is entered and verified by different operators, increases the possibility of data entry errors.

**KENTUCKY REVENUE CABINET
SCHEDULE OF FINDINGS AND QUESTIONED COSTS
FOR THE YEAR ENDED JUNE 30, 1998
(CONTINUED)**

**SECTION 2 – FINANCIAL STATEMENT FINDINGS AND QUESTIONED COSTS
(CONTINUED)**

Other Matters Relating To Internal Controls And/Or Compliance(Continued)

FINDING 98-KRC-2: The Revenue Cabinet Data Entry Section Supervisor Should Ensure That All Batches Are Keyed And Verified By Separate Operators (Continued)

A complete log recording the date, the original entry operator number, and the verifying operator number should be kept. The log should be reviewed daily for missing information and batches that were entered and verified by the same operator. Further, data entered into the computer system should be verified unless there are sufficient internal controls in place to ensure the accuracy of the data. An operator other than the original entry operator, if necessary, should perform this verification.

Recommendation

We recommend that data entry section supervisors ensure that all batches are keyed and verified by separate operators. Further, supervisors should review data entry logs daily to ensure completeness and proper segregation of duties.

Management Response and Corrective Action Plan

The Kentucky Revenue Cabinet (KRC) Division of Revenue Operations agrees with the Auditors' findings. In the future the data entry supervisors will review the logs daily to ensure completeness and proper segregation of duties between the initial operator and the verifier. They will also take the necessary corrective action when the data entry log is improperly completed (i.e., missing operator ID number, identical ID numbers for the keying and verifying operator.

FINDING 98-KRC-3: The Revenue Cabinet Should Ensure That Motor Fuel Reports Are Cross-Checked As Required

The Revenue Cabinet – Motor Fuels Section appears to have changed its procedures for cross-checking certain reports and does not appear to be able to complete all tasks associated with the new procedures. Some reports that were previously cross-checked when received are now cross-checked when the dealer is selected for a comprehensive audit. This results in schedules and Dealer Reports not being processed in the manner that was described in a control procedure for this process.

Office examiners are to cross-check Dealer Reports and Schedules when received and stamp the Dealer Report "Cross-checked" in red to indicate that the cross-check was completed, per the control procedure.

During our test of Motor Fuel Dealer Reports, only six of the forty-five returns examined had been cross-checked. This apparently is due to the change in procedures and a backlog of work in the Motor Fuels Section which they estimate at 3 ½ years.

**KENTUCKY REVENUE CABINET
SCHEDULE OF FINDINGS AND QUESTIONED COSTS
FOR THE YEAR ENDED JUNE 30, 1998
(CONTINUED)**

**SECTION 2 – FINANCIAL STATEMENT FINDINGS AND QUESTIONED COSTS
(CONTINUED)**

Other Matters Relating To Internal Controls And/Or Compliance(Continued)

FINDING 98-KRC-3: The Revenue Cabinet Should Ensure That Motor Fuel Reports Are Cross-Checked As Required (Continued)

The inability to timely cross-check the various schedules and reports compromises the design of the structure as a whole and may reduce the effectiveness of the system to efficiently detect errors, omissions or irregularities in a timely fashion.

Recommendation

We recommend that Revenue take the appropriate steps necessary to ensure adequate staff is available to complete all tasks associated with their system of controls. This may be accomplished by increasing staff levels or comprehensively redesigning controls in a manner which would require less staff.

Management's Response and Corrective Action Plan

The Kentucky Revenue Cabinet (KRC) agrees with the Auditor's findings. However, the KRC does allocate staffing resources among both taxpayer assistance and taxpayer compliance programs, but does not have additional staffing resources to cross check Motor Fuels returns. The Motor Fuels Tax Section is participating in a cross training project whereby employees receive training on multiple taxes in order to provide taxpayer assistance on all type taxes. The Motor Fuels Tax Section is in the process of examining its audit selection procedures for assigning field audits. Returns that are assigned for field audit will be cross-checked. The KRC intends to identify large deficiencies through the audit selection process so that such deficiencies are assessed prior to the expiration of the 5-year statute of limitations. We also plan on automating the cross checking process within the next three to five years, whereby a computer program will perform the cross checking of Motor Fuel Tax returns.

**KENTUCKY REVENUE CABINET
SCHEDULE OF FINDINGS AND QUESTIONED COSTS
FOR THE YEAR ENDED JUNE 30, 1998
(CONTINUED)**

SECTION 3 – FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

There were no federal award audit findings for the Revenue Cabinet.

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS

**KENTUCKY REVENUE CABINET
SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 1998**

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
<u>Material Conditions</u>					
<i>(1) Audit findings that have been fully corrected:</i>					
		N/A			
<i>(2) Audit findings not corrected or partially corrected:</i>					
1995	97-REV- 24	The Revenue Cabinet Should Utilize The Automatic Log-Off Feature For Information Management Systems And Customer Information Control System Applications	N/A	0	Some progress has been made in these areas; however, formal procedures had not been implemented for FY 98.
1996	97-REV- 25	The Revenue Cabinet Computer System Must Be Modified In Order To Process Year 2000 Data	N/A	0	Year 2000 compliance conversions were not complete for FY 98.
1996	97-REV- 26	The Revenue Cabinet Needs To Improve Tracking Procedures For Contingent Liabilities	N/A	0	KRC intends to modify the necessary reports to better track contingent liabilities; however, all revisions were not made for FY 98.
<i>(3) Corrective action taken is significantly different from corrective action previously reported:</i>					
		N/A			
<i>(4) Audit finding is no longer valid:</i>					
1995	97-REV- 23	The Revenue Cabinet Should Improve Receipt Procedures (Date Stamp)	N/A	0	Two years have passed. KRC management is adhering to the provisions of KRS 41.070 by depositing funds in the most prompt and cost-efficient manner possible given current staffing.

**KENTUCKY REVENUE CABINET
SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 1998**

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
<u>Other Matters</u>					
<i>(1) Audit findings that have been fully corrected:</i>					
1997	KRC – 5	The Revenue Cabinet Should Properly Safeguard Sales And Use Tax Returns	N/A	0	This was corrected for the Sales and Use tax type returns for the year ended June 30, 1998.
1996	KRC – 9	The Revenue Cabinet Should Ensure That Refunds For Motor Fuels Are Properly Coded	N/A	0	Auditor found all refunds properly coded for the year ended June 30, 1998.
1995	KRC – 10	The Revenue Cabinet Should Develop A Disaster Recovery Plan	N/A	0	Plan was implemented for the year ended June 30, 1998.
<i>(2) Audit findings not corrected or partially corrected:</i>					
1996	KRC – 8	The Revenue Cabinet Should Have Procedures To Document Refund Requests As They Come Into The Revenue Cabinet	N/A	0	KRC intends to establish a Standard Procedure for tracking all refund requests and the proposed Kentucky Integrated Tax Entity System (KITES) will provide KRC with the capabilities to track contingent liabilities more efficiently; however, for the year ended June 30, 1998, this was not fully implemented.
1996	KRC – 11	The Revenue Cabinet Should Have Adequate Written Security Policies And Procedures Identifying Management And User Responsibilities For System Security	N/A	0	Various policies and procedures are being written and distributed to applicable KRC employees; however, all were not issued for the year ended June 30, 1998.
1996	KRC – 12	The Revenue Cabinet Should Strengthen Physical Security At The Perimeter Park Building	N/A	0	KRC began work on some of the areas of concern for physical security; however, they were not fully implemented for the year ended June 30, 1998.

**KENTUCKY REVENUE CABINET
SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 1998**

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
<u>Other Matters</u>					
<i>(3) Corrective action taken is significantly different from corrective action previously reported:</i>					
1997	KRC – 6	The Revenue Cabinet Should Properly Safeguard Motor Fuel And Motor Usage Returns	N/A	0	Returns requested in testing were missing from Central Files, this will be repeated for the year ended June 30, 1998. See comment 98-KRC-1.
1997	KRC – 7	The Revenue Cabinet Should Properly Safeguard Corporation Tax Returns	N/A	0	Area was not significant to the general-purpose financial statements for the year ended June 30, 1998; however, this was noted in other tax types, see comment 98-KRC-1.

(4) Audit finding is no longer valid:

N/A